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DEPARTMENT OF THE TREASURY

Internal Revenue Bulletin: 2005-23**June 6, 2005****Notice 2005-42*****Modification of Application of Rule Prohibiting Deferred Compensation Under a Cafeteria Plan*****Table of Contents**

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PURPOSE

The purpose of this notice is to modify the application of the rule prohibiting deferred compensation under a § 125 cafeteria plan. This notice permits a grace period immediately following the end of each plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during the grace period.

BACKGROUND

In general, no amount is included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Section 125(a). A cafeteria plan is defined in § 125(d)(1) as a written plan maintained by an employer under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits. Section 125(f) defines a "qualified benefit" as any benefit which, with the application of § 125(a), is not includable in the gross income of the employee by reason of an express provision of Chapter I of the Internal Revenue Code (other than §§ 106(b), 117, 127 or 132). Qualified benefits include employer-provided accident and health plans excludable from gross income under §§ 106 and 105(b), group-term life insurance excludable under § 79, dependent care assistance programs excludable under § 129 and adoption assistance programs excludable under § 137. Elections under a cafeteria plan, once made, can be changed or revoked only as provided in Treas. Reg. § 1.125-4. A cafeteria plan must have a plan year specified in the written plan document. Prop. Treas. Reg. § 1.125-1, Q&A-3.

Section 125(d)(2)(A) states that the term "cafeteria plan" does not include any plan which provides for deferred compensation. The statutory prohibition on deferred compensation in a cafeteria plan is addressed in Prop. Treas. Reg. §§ 1.125-1 and 1.125-2. Prop. Treas. Reg. § 1.125-2, Q&A-5 states that:

A cafeteria plan may not include any plan that offers a benefit that defers the receipt of compensation. In addition, a cafeteria plan may

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not operate in a manner that enables employees to defer compensation. For example, a plan that permits employees to carry over unused elective contributions or plan benefits (e.g., accident or health plan coverage) from one plan year to another operates to defer compensation. This is the case regardless of how the contributions or benefits are used by the employee in the subsequent plan year (e.g., whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type). Similarly, a cafeteria plan operates to permit the deferral of compensation if the plan permits participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year ...

See also Prop. Treas. Reg. § 1.125-1, Q&A-7.

Thus, a cafeteria plan does not include any plan that defers the receipt of compensation or operates in a manner that enables participants to defer compensation by, for example, permitting participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year. This rule is commonly referred to as the "use-it-or-lose-it" rule, requiring that unused contributions or benefits remaining at the end of the plan year be "forfeited."

However, other areas of tax law provide that for a short, limited period, compensation for services paid in the year following the year in which the services that are being compensated were performed is not treated as "deferred compensation." For example, Treas. Reg. § 1.404(b)-1T, Q&A-2(a) provides that for purposes of the deduction rules in § 404(a), (b) and (d), a plan, or method or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. Under Treas. Reg. § 1.404(b)-1T, Q&A-2 (c), a plan, or method or arrangement shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the fifteenth day of the third calendar month after the end of the employer's taxable year in which the services are rendered. See also *Weaver v. Commissioner*, 121 T.C. 273 (2003); Rev. Rul. 88-68, 1988-2 C.B. 117. Cf. H. R. Conf. Rep. No. 755, 108th Cong., 2d Sess. at 735 (2004) (§ 409A "does not apply to annual bonuses or other annual compensation amounts paid within 2 and 1/2 months after the close of the taxable year in which the relevant services required for payment have been performed"). Consistent with these other areas of tax law, Treasury and the IRS believe it is appropriate to modify the current prohibition on deferred compensation in the proposed regulations under § 125 to permit a grace period after the end of the plan year during which unused benefits or contributions may be used.

MODIFICATION OF APPLICATION OF RULE PROHIBITING DEFERRED COMPENSATION UNDER A § 125 CAFETERIA PLAN

The rule that a cafeteria plan may not defer the receipt of compensation as set out in Prop. Treas. Reg. §§ 1.125-1 and 1.125-2 is modified as follows: A cafeteria plan document may, at the employer's option, be amended to provide for a grace period immediately following the end of each plan year. The grace period must apply to all participants in the cafeteria plan. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the immediately preceding plan year. The grace period must not extend beyond the fifteenth day of the third calendar month after the end of the immediately preceding plan year to which it relates (i.e., "the 2 and 1/2 month rule"). If a cafeteria plan document is amended to include a grace period, a participant who has unused benefits or contributions relating to a particular qualified benefit from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses had been incurred in the immediately preceding plan year. The effect of the grace period is that the participant

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may have as long as 14 months and 15 days (the 12 months in the current cafeteria plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are "forfeited" under the "use-it-or-lose-it" rule.

During the grace period, a cafeteria plan may not permit unused benefits or contributions to be cashed-out or converted to any other taxable or nontaxable benefit. Unused benefits or contributions relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to that particular qualified benefit. For example, unused amounts elected to pay or reimburse medical expenses in a health flexible spending arrangement (FSA) may not be used to pay or reimburse dependent care or other expenses incurred during the grace period. To the extent any unused benefits or contributions from the immediately preceding plan year exceed the expenses for the qualified benefit incurred during the grace period, those remaining unused benefits or contributions may not be carried forward to any subsequent period (including any subsequent plan year) and are "forfeited" under the "use-it-or-lose-it" rule. As under current practice, employers may continue to provide a "run-out" period after the end of the grace period, during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

An employer may adopt a grace period as authorized in this notice for the current cafeteria plan year (and subsequent cafeteria plan years) by amending the cafeteria plan document before the end of the current plan year.

The rules of this notice are illustrated by the following examples:

Example (1). Employer with a cafeteria plan year ending on December 31, 2005, amended the plan document before the end of the plan year to permit a grace period which allows all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. The grace period adopted by the employer ends on the fifteenth day of the third calendar month after the end of the plan year (March 15, 2006, for the plan year ending December 31, 2005). Employee X timely elected salary reduction of \$1,000 for a health FSA for the plan year ending December 31, 2005. As of December 31, 2005, X has \$200 remaining unused in his health FSA. X timely elected salary reduction for a health FSA of \$1,500 for the plan year ending December 31, 2006. During the grace period from January 1 through March 15, 2006, X incurs \$300 of unreimbursed medical expenses (as defined in § 213(d)). The unused \$200 from the plan year ending December 31, 2005, is applied to pay or reimburse \$200 of X's \$300 of medical expenses incurred during the grace period. Therefore, as of March 16, 2006, X has no unused benefits or contributions remaining for the plan year ending December 31, 2005. The remaining \$100 of medical expenses incurred between January 1 and March 15, 2006, is paid or reimbursed from X's health FSA for the plan year ending December 31, 2006. As of March 16, 2006, X has \$1,400 remaining in the health FSA for the plan year ending December 31, 2006.

Example (2). Same facts as Example (1), except that X incurs \$150 of § 213(d) medical expenses during the grace period (January 1 through March 15, 2006). As of March 16, 2006, X has \$50 of unused benefits or contributions remaining for the plan year ending December 31, 2005. The unused \$50 cannot be cashed-out, converted to any other taxable or nontaxable benefit, or used in any other plan year (including the plan year ending December 31, 2006). The unused \$50 is subject to the "use-it-or-lose-it" rule and is "forfeited." As of March 16, 2006, X has the entire \$1,500 elected in the health FSA for the plan year ending December 31, 2006.

EFFECT ON OTHER DOCUMENTS

Future guidance will modify Prop. Treas. Reg. §§ 1.125-1 and 1.125-2 to reflect the provisions in this notice.

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The principal author of this notice is Elizabeth Purcell of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Purcell at (202) 622-6080 (not a toll-free call).

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